January 29, 2018

Delaware Supreme Court Confirms Applicability of Issue Preclusion to Dismissals of Shareholder Derivative Actions for Failure to Plead Demand Futility

Court Rejects Chancery Court's Proposed Rule That Issue Preclusion Applies Only if Derivative Plaintiffs Survive Motion to Dismiss

SUMMARY

In *California State Teachers' Retirement System* v. *Alvarez*, the Delaware Supreme Court, sitting *en banc*, unanimously declined to adopt the Court of Chancery's proposed rule that, as a matter of federal due process, "a judgment in a derivative action cannot bind a corporation or other stockholders until the suit has survived a Rule 23.1 motion to dismiss."[1] The Delaware Supreme Court held that due process does not prohibit giving preclusive effect to a dismissal for failure to plead demand futility as against subsequent derivative plaintiffs unless the earlier derivative plaintiffs were not adequate representatives of the corporation's interests. This opinion confirms, consistent with federal court rulings, that, in most circumstances, dismissal of a shareholder derivative claim for failure to plead demand futility will have a preclusive effect on shareholder suits brought in other jurisdictions.

BACKGROUND

In April 2012, the *New York Times* reported on an alleged bribery scheme and subsequent cover-up by executives of Wal-Mart's Mexican division. Multiple derivative suits followed, including in a federal court in Arkansas and in Delaware Chancery Court. The Delaware plaintiffs made a books-and-records demand pursuant to *8 Del. C.* § 220, while the Arkansas plaintiffs proceeded without such a demand.

While litigation concerning the Delaware plaintiffs' Section 220 demand was pending, Wal-Mart moved to dismiss the Arkansas action pursuant to Federal Rule of Civil Procedure 23.1, arguing that the Arkansas plaintiffs failed to sufficiently plead that demand on Wal-Mart's board of directors would have been futile. After initially staying the federal action, the Arkansas court granted the motion to dismiss. Wal-Mart then moved to dismiss the Delaware plaintiffs' action on the ground that the Arkansas decision had preclusive effect on the issue of demand futility.

Although the Court of Chancery initially granted Wal-Mart's motion and dismissed the Delaware plaintiffs' lawsuit, the Delaware Supreme Court (in a previous appeal) remanded for the Chancery Court to consider whether "the subsequent stockholders' Due Process rights [have] been violated" by giving preclusive effect to the Arkansas federal court's dismissal.[2] The Court recognized that potential problems could arise when one plaintiff makes a books-and-records demand and another, less thorough, plaintiff advances more quickly to the motion-to-dismiss stage. The Delaware Supreme Court pointed the Chancery Court to the U.S. Supreme Court's decision in *Smith* v. *Bayer Corp.*, which considered issue preclusion in the context of pre-certification class actions and held that "[n]either a proposed class action nor a rejected class action may bind nonparties."[3]

On remand, although recognizing that the weight of the authority goes in the other direction, the Chancery Court recommended that the Delaware Supreme Court adopt a rule that derivative litigation does not have preclusive effect against subsequent stockholders unless the earlier plaintiffs have survived a Rule 23.1 motion to dismiss.[4] The Chancery Court believed "that such a rule would 'better safeguard the due process rights of stockholder plaintiffs and should go a long way to addressing fast-filer problems currently inherent in multi-forum derivative litigation.'"[5]

THE DELAWARE SUPREME COURT'S DECISION

The Delaware Supreme Court declined to adopt the Chancery Court's recommendation and affirmed the Chancery Court's original dismissal of the Delaware plaintiffs' action on preclusion grounds. Noting that three federal courts of appeals had agreed that it does not violate due process to grant preclusive effect to prior determinations of demand futility, the Court refused to adopt the categorical rule proposed by the Chancery Court. Instead, the Court held that "the Due Process rights of subsequent derivative plaintiffs are protected, and dismissal based on issue preclusion is appropriate, when their interests were aligned with and were adequately represented by the prior plaintiffs."[6] More specifically, "for issue preclusion to apply, the party asserting issue preclusion must satisfy the court that, first, all elements of issue preclusion are present and, second, Due Process requirements are satisfied."[7]

Applying that test to this case, the Delaware Supreme Court first concluded that derivative plaintiffs met the Arkansas standards for privity, which "exists when two parties are so identified with one another that they represent the same legal right."[8] In the "first stage of a derivative action (assertion of demand

futility)," derivate plaintiffs are "permitted to litigate only the board's capacity to control the corporation's claims"; in other words, the "suit is always about the corporation's right to seek redress for alleged harm to the corporation."[9] The Court noted that this was an essential distinction from the class action context at issue in *Smith* v. *Bayer Corp.*, where the named plaintiff acts solely in an individual capacity until the court certifies the class. In the derivative context, by contrast, "when multiple derivative actions are filed (in one or more jurisdictions), the plaintiffs share an identity of interest in seeking to prosecute claims by and in the right of the same real party in interest—*i.e.*, as representatives of—the corporation."[10] As a result, "differing groups of stockholders who seek to control the corporation's cause of action share the same interest and therefore are in privity."[11]

Turning to the due process analysis, the Court acknowledged the general rule that "'one is not bound by a judgment *in personam* in a litigation in which he is not designated as a party or to which he has not been made a party by service of process,'"[12] but noted that there is an exception where a nonparty "may be bound by a judgment because she was *adequately represented* by someone with the same interests who [wa]s a party to the suit.'"[13] The due process analysis thus turned on whether the Arkansas plaintiffs were adequate representatives of the corporation's interests.

The Delaware plaintiffs' principal argument for why the Arkansas plaintiffs were not adequate representatives was based on the Restatement (Second) of Judgments, which states that adequate representation does not exist where "the prior representative . . . 'failed to prosecute or defend the action with due diligence and reasonable prudence' such that 'the opposing party was on notice of facts making that failure apparent.'"[14] Drawing from the comments to that section, the Delaware Supreme Court held that prior representation will be deemed inadequate only where the conduct of the prior litigation was "grossly deficient" or where the first-in-time plaintiffs had a conflict of interest such that they pursued their interests at the expense of the second-in-time plaintiffs.[15] The Court found that neither of these showings had been made here. The Court stated that the Arkansas plaintiffs' representation was not "grossly deficient" simply because they had not made a Section 220 demand for books and records, noting that the Arkansas plaintiffs instead chose to rely on internal Wal-Mart documents that were made public by the *New York Times* article. While that may have turned out to be a "tactical error," the Court explained that it was a considered decision on which "[r]easonable litigants can differ" in the context of this case. And because the Delaware plaintiffs had made no showing that the Arkansas plaintiffs' interests were adverse to those of Wal-Mart, the Court found no conflict of interest or suggestion that the Arkansas plaintiffs pursued their claim at the expense of the Delaware plaintiffs.

IMPLICATIONS

The Delaware Supreme Court's opinion confirms that dismissals on the ground that derivative plaintiffs have failed to plead demand futility will generally have preclusive effect in subsequent derivative actions, ensuring that boards of directors will not be required to repeatedly relitigate the issue of demand futility in

multiple derivative lawsuits across various jurisdictions. While the Court noted that the Arkansas plaintiffs had access to internal Wal-Mart documents when they decided not to pursue a books and records demand, it did not set a categorical rule regarding what constitutes adequate representation such that issue preclusion binds the second-in-time plaintiffs.

* * *

ENDNOTES

1 No. 295, 2016, at 2 (Del. 2018).

2 *Cal. State Teachers' Retirement Sys.* v. *Alvarez*, 2017 WL 6421389, at *1, *5, *8 (Del. Jan. 18, 2017).

3 564 U.S. 299, 315 (2011).

4 No. 295, 2016, at 20.

5 *Id.* at 21 (quoting *In re Wal-Mart Stores Inc. Del. Deriv. Litig.*, 167 A.3d 513, 516 (Del. Ch. 2017)).

6 *Id.* at 21.

7 *Id.* at 25.

8 *Id.* at 27 (quoting *Crockett* v. *C.A.G. Invest., Inc.*, 381 S.W.3d 793, 799 (Ark. 2011)).

9 *Id.* at 32.

10 *Id.* at 33-34.

11 *Id.* at 34.

12 *Id.* at 38 (quoting *Taylor* v. *Sturgell*, 553 U.S. 880, 893 (2008)).

13 *Id.* (quoting *Taylor*, 553 U.S. at 894 (alteration in original) (internal quotation marks omitted)).

14 *Id.* at 42 (quoting Restatement (Second) of Judgments § 42(1)(e)).

15 Restatement (Second) of Judgments § 42, cmt. f.

ABOUT SULLIVAN & CROMWELL LLP

Sullivan & Cromwell LLP is a global law firm that advises on major domestic and cross-border M&A, finance, corporate and real estate transactions, significant litigation and corporate investigations, and complex restructuring, regulatory, tax and estate planning matters. Founded in 1879, Sullivan & Cromwell LLP has more than 875 lawyers on four continents, with four offices in the United States, including its headquarters in New York, four offices in Europe, two in Australia and three in Asia.

CONTACTING SULLIVAN & CROMWELL LLP

This publication is provided by Sullivan & Cromwell LLP as a service to clients and colleagues. The information contained in this publication should not be construed as legal advice. Questions regarding the matters discussed in this publication may be directed to any of our lawyers listed below, or to any other Sullivan & Cromwell LLP lawyer with whom you have consulted in the past on similar matters. If you have not received this publication directly from us, you may obtain a copy of any past or future publications by sending an e-mail to SCPublications@sullcrom.com.

CONTACTS

New York		
Brian T. Frawley	+1-212-558-4983	frawleyb@sullcrom.com
Joseph B. Frumkin	+1-212-558-4101	frumkinj@sullcrom.com
Robert J. Giuffra Jr.	+1-212-558-3121	giuffrar@sullcrom.com
John L. Hardiman	+1-212-558-4070	hardimanj@sullcrom.com
Stephen M. Kotran	+1-212-558-4963	kotrans@sullcrom.com
William B. Monahan	+1-212-558-7375	monahanw@sullcrom.com
Richard C. Pepperman II	+1-212-558-3493	peppermanr@sullcrom.com
Matthew A. Schwartz	+1-212-558-4197	schwartzmatthew@sullcrom.com
Washington, D.C.		
Amanda Flug Davidoff	+1-202-956-7570	davidoffa@sullcrom.com
Daryl A. Libow	+1-202-956-7650	libowd@sullcrom.com
Judson O. Littleton	+1-202-956-7085	littletonj@sullcrom.com
Christopher M. Viapiano	+1-202-956-6985	viapianoc@sullcrom.com
Los Angeles		
Eric M. Krautheimer	+1-310-712-6678	krautheimere@sullcrom.com
Alison S. Ressler	+1-310-712-6630	resslera@sullcrom.com
Robert A. Sacks	+1-310-712-6640	sacksr@sullcrom.com